

VZCZCXRO7596
RR RUEHRG
DE RUEHSO #0119/01 0451255
ZNR UUUUU ZZH
R 141255Z FEB 07
FM AMCONSUL SAO PAULO
TO RUEHC/SECSTATE WASHDC 6421
INFO RUEHBR/AMEMBASSY BRASILIA 7514
RHEHNSC/NSC WASHDC
RUCPDOC/USDOC WASHDC 2707
RUEHMN/AMEMBASSY MONTEVIDEO 2269
RUEHBU/AMEMBASSY BUENOS AIRES 2636
RUEHSG/AMEMBASSY SANTIAGO 1984
RUEHLP/AMEMBASSY LA PAZ 3222
RUEHPE/AMEMBASSY LIMA 1101
RUEHCV/AMEMBASSY CARACAS 0444
RUEHBO/AMEMBASSY BOGOTA 1492
RUEHRG/AMCONSUL RECIFE 3369
RUEHRI/AMCONSUL RIO DE JANEIRO 7783
RUEHAC/AMEMBASSY ASUNCION 2926
RUEATRS/DEPT OF TREASURY WASHDC
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RUEAWJC/DEPT OF JUSTICE WASHDC

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STATE PASS TO USTR FOR MSULLIVAN
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NSC FOR FEARS
USDOC FOR 4332/ITA/MAC/OLAC
USDOC FOR 3134/USFCS/OIO
TREASURY FOR OASIA, DAS LEE AND JHOEK
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SUBJECT: ICMS Tax Benefits Issue: Financial Concerns for U.S.
companies, Sao Paulo State and Brazil

REF: (A) SAO PAULO 36; (B) 06 SAO PAULO 675

SENSITIVE BUT UNCLASSIFIED; PLEASE PROTECT ACCORDINGLY

Summary

¶1. (SBU) Consul General convened representatives of US and Brazilian companies at ConGen Sao Paulo on January 19 to discuss ongoing issues associated with tax benefits (ICMS - rough VAT equivalent collected at the state level) granted by the Sao Paulo state government. Motorola and other electronics exporting companies have received ICMS tax benefits, which has encouraged investment in the state. Similar incentives have been granted by other states to various industry sectors, generating "tax wars" and resulting in lawsuits between states. Parana state had filed a suit against Sao Paulo state in 2001, arguing that the granting of tax incentives without the agreement of all the other states violated the Brazilian Constitution. The case was scheduled to be ruled upon by the Supreme Court (STF) on February 2. If the decision were to go against Sao Paulo, the decree governing the tax incentives could have been declared unconstitutional, resulting in the cancellation of the benefits with the possibility of retroactive tax liabilities for the companies. This would represent a loss of hundreds of millions of dollars and jeopardize the continued presence in Sao Paulo of a number of companies, as well as the plans of at least one company to move its operations to the state. Rather than risk this outcome, Sao Paulo state governor Serra, responding in part to concerns raised by Ambassador Sobel and ConGen Sao Paulo, revoked the existing state decree on January 30 in a legal maneuver to vacate the existing lawsuit. Sao Paulo state intends to replace it

in the next fifteen days with a new decree retroactively granting U.S. and other companies identical benefits. ConGen and the Embassy plan to work with U.S. companies, the Sao Paulo government and the federal government to encourage a long-term solution to the ICMS quandary. End Summary.

Background

¶2. (U) In order to develop and maintain industrial capacity manufacture and create greater investment in Brazil, many states have offered tax incentives to companies investing and operating in the state. These take the form of credits to exporters on the state Tax on the Circulation of Merchandise and Services (ICMS - VAT equivalent administered and collected by state governments). Sao Paulo state, as one of Brazil's major industrial centers, representing 31 percent of Brazil's GDP, also has offered such incentives. However, the rivalry between states has led to "tax wars," and frequent lawsuits. The Sao Paulo state government has adopted the legal tactic, once an unfavorable court ruling is nigh, of revoking the decree governing the tax credits and then immediately issuing a new one. This results in the vacating of the lawsuit against the old law but allows companies to continue to receive their tax credits. However, as the legal action of Parana vs. Sao Paulo concerning ICMS credits for electronics manufacturers made its way to the Supreme Court, companies became increasingly concerned that this tactic was not providing a durable solution to the continuing threat of adverse rulings and the possible loss of hundreds of millions of dollars. For this reason, they requested the USG's assistance in encouraging the new Governor to work on a more durable, long-term solution.

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ICMS Tax Benefits: The Need for a Permanent Solution

¶3. (U) ConGen hosted a series of meetings with affected companies to discuss issues surrounding state ICMS benefits. Initially, Motorola had approached the Consul General (CG) and the Ambassador to express their concerns. On January 19th, CG convened a second meeting that included additional companies and industry representatives facing this same problem. Brazilian and U.S. companies, including Motorola, Flextronics, Dell, and Hewlett Packard, along with representatives of the electronics trade association ABINEE, Amcham and the state Federation of Industries (FIESP), met with the CG, Econ/Pol, and FCS.

¶4. (U) All in attendance at this meeting, which took place before Governor Serra revoked the old tax benefit legislation, agreed that even if the tax issue is resolved temporarily, as it has been in the past, there needs to be a longer term solution to the problem. The companies cannot continue to operate in a climate of instability and uncertainty; they have other options in terms of investment, such as India, China and Mexico. Sao Paulo state is particularly affected, as a large number of U.S. and other companies that employ thousands of people are based here. These companies depend on ICMS credits to make their operations viable. For example, Dell had decided to relocate from Rio Grande do Sul to Sao Paulo specifically because of the ICMS benefits. Otherwise, the costs of production and problems with security would weigh against investing in Sao Paulo. Ultimately, there needs to be a long term solution.

¶5. (U) It was resolved that ABINEE, the electronics trade association, would take the lead and coordinate efforts to bring about a resolution. In addition to approaching the state and federal governments, ABINEE decided to seek the support of CONFAZ, the National Council for Fiscal Policy. CONFAZ is an organization comprising the Secretaries of Finance of all 27 states; its members discuss important federal and state fiscal matters. Created to allow the federal government and state tax authorities to jointly manage ICMS, CONFAZ is perhaps the best vehicle to begin to tackle the ICMS problem. ABINEE met recently with Sao Paulo Finance Secretary Mauro Ricardo Machado Costa and several members of

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Brazil's Congress to emphasize the importance of resolving this issue.

Meetings with the Ambassador: Weighing in on the Issue

¶6. (U) In an effort to assist in resolving this issue, Ambassador Sobel raised the ICMS benefits problem in a January 10 meeting with Governor Serra in Sao Paulo (ref A) and later with Minister of Development, Industry, and Foreign Trade Luiz Fernando Furlan in Brasilia. Minister Furlan responded that this was a state issue and had to be resolved among the governors. Governor Serra, for his part, gave assurances that he would revoke the tax incentives and then reinstate them.

Sao Paulo State: Concerns, Actions, and Future Plans

¶7. (U) On January 30, the decree governing the ICMS credits was officially revoked by the Sao Paulo state government. After the revocation, industry and ConGen took action on two fronts: 1) ABINEE convened a meeting of all concerned companies that day to meet and draft recommended language for the new decree, which they

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will submit to the state government, and 2) on the following day, CG met with Vice Governor Alberto Goldman to discuss the revocation and future actions of the state government to resolve the ICMS issue. Responding to the CG's concerns about the impact of this issue on U.S. companies, Goldman reiterated the government's intention to issue a new decree restoring the credits within 15 days. The 15-day waiting period, Goldman explained, was not required by law but rather was based on "public image" concerns. Goldman implied that an immediate turnaround would not be viewed in a positive light by the Supreme Court; for the sake of appearances, it was better to allow a decent interval before issuing a replacement decree. Although it was not clear whether the companies would be able to re-coup revenue losses incurred during this 15-day period, Goldman suggested that such losses would not be too detrimental since they would be shared equally throughout the sector. He was aware that a new decree will be only a temporary solution and agreed on the urgent need to find a longer term solution. He also confirmed that the state government has created an internal working group to develop a proposal for a permanent solution, which he hopes to present to the federal government in the next three months.

¶8. (SBU) Goldman is confident that the states will reach a solution to these "tax wars," as he considers Sao Paulo State to be the "heavy hitter" in the war, and the most influential state in negotiating a modus vivendi with the others. "We don't want to fight a war, we want to find a peaceful solution everyone can live with," Goldman said. "If we go to war, everybody loses. But if it does come to that, we have the ammunition and will win." He is also of the opinion that this early stage in President Lula's second administration offers an opportune moment to find a solution, implying that if there is a long delay in resolving the problem, the chances for reaching a successful conclusion would diminish. He also considers that CONFAZ could be a major player in resolving this issue, as a solution reached by this organization would motivate the GOB to enter into serious talks to resolve the issue. Goldman suggested that Ambassador Sobel could talk with Minister Furlan and Finance Minister Guido Mantega, and with Lula's Chief of Staff, Dilma Rousseff. Another opportunity to resolve the issue would be to approach Governors from the major states involved.

COMMENT

¶9. (SBU) Comment: At present, all the companies are waiting for the re-issuance of the new tax benefits decree, which they hope will include some of their input. Upon re-issuance, the ICMS tax benefits issue will be temporarily resolved, but a permanent solution is necessary to create a stable financial climate for present and future business investment. Based on our meetings with Governor Serra and Vice-Governor Goldman, we believe Sao Paulo state understands what is at stake and is committed to resolving the

issue, which represents hundreds of millions of dollars to the companies, and affects future investment in the state. After years of tax wars, revocations, and re-issuances, it appears that the Sao Paulo government is ready to roll up its collective sleeves and attempt to tackle this problem, and hopes to carry the rest of Brazil along with it. Prospects for Sao Paulo state carrying the day on the issue, however, are not at all clear. It is likely that any reform of the ICMS system, which necessarily raises a host of thorny fiscal federalism issues, will require clear federal government leadership in the Confaz and in the federal congress. The last serious attempt to reform the ICMS system, an ambitious effort that incidentally would have grandfathered and frozen

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existing tax breaks to companies, was roundly defeated in 2004 as many states proved unable or unwilling to compromise on changes to the tax that is their main source of income. End Comment.

¶12. (U) This cable was coordinated with Embassy Brasilia.

McMullen